Finance companies industry developments - 1992; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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Finance Companies
Industry Developments—1992

Update to AICPA Audit and Accounting Guide
Audits of Finance Companies
NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of finance companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

Finance companies provide a wide variety of lending and financing services to both consumers and business enterprises. Some limit their lending activities to financing purchases of products produced by an affiliated company. Others concentrate on lending to consumers. Still others have diversified into higher-risk lending to real estate and takeover ventures, and have come to compete with banks and savings institutions.

Finance companies that have limited their lending activities primarily to customers financing purchases of products produced by affiliated companies are reporting fairly strong operating results. Indeed, some appear to be doing better than the recession-pressed producers of the products they finance. This segment of the industry has been able to benefit from the widening interest rate spread or differential between the rates paid to raise capital to lend and the rates charged to borrowers. In addition, the conservative nature of lending only to customers buying company-produced products appears to have reduced credit quality problems in most instances.

Banks and savings institutions across the country have been sharply decreasing their lending activities. The major reasons for this are as follows: Consumers are paying down debt; the slow economy has squelched borrowers' confidence; regulators are more closely monitoring the levels of risk in the loan portfolios of such institutions. As a result, companies that formerly dealt only with banks are now turning to commercial finance companies. An indication of this trend is that for the past nine years, the nation's largest purveyor of loans backed by the Small Business Administration has been not a bank but a commercial finance company. While this seems encouraging for finance companies, the fact remains that the overall demand for loans is low for both banks and finance companies in this sluggish economy. Total business credit has remained flat since the recession began in mid-1990. With interest rates at 30-year lows, borrowers have raised $45.4 billion in the capital markets to pay off bank debt since the first quarter of 1990.

Finance companies that have diversified into higher-risk lending activities such as equipment finance, accounts receivable lending, and commer-
cial real estate lending are not faring as well. Such companies are finding themselves exposed to many of the same pressures as banks and savings institutions. Those pressures include the effects of an economy struggling to recover from recession and are reflected in declining credit quality and increasing credit risk.

Auditors of finance companies should fully understand the types of lending activities in which their clients are engaged and carefully consider the risks inherent in each type of activity. Auditors should also be alert to red flags that indicate areas of increased risk requiring particular audit consideration. Such red flags include—

- Material changes in operations or operating performance that may indicate deteriorating financial strength. Such changes include increasing loan delinquencies or loss charge-offs, declining interest spreads, lower ratios of loan-loss allowances to nonperforming loans in comparison to industry averages, and practices that reflect a failure to consider changing economic conditions (for example, over-reliance on historical data in evaluating allowances for loan losses).

- Material, one-time transactions that may indicate attempts to realize large, short-term benefits, particularly when such transactions occur at or near the end of a reporting period or account for a material portion of reported income. Such transactions may include high-volume purchases or sales of assets (such as mortgage-servicing rights), speculative or unusual off-balance-sheet arrangements, and other high rates of asset growth or disposition. Auditors should give particular attention to the propriety of the accounting treatment of such transactions.

- Highly complex or speculative investments, such as complex mortgage derivatives, investments in noninvestment-grade securities, or complicated, multiple-step transactions involving real estate. Auditors should consider the propriety of management's valuation of such investments and evaluate management's assessment of their recoverability.

- Nontraditional or unusual loan transactions that may expose the company to increased risk. Such transactions include loans with unusual, questionable, or inadequate collateral; loans outside the company's normal lending area; poorly documented loans; loans that pay interest from interest reserves; loans secured by collateral that has dramatically changed in value; significant concentrations of loans; loans to real estate ventures that represent equity investments (acquisition, development, and construction loans); and practices such as routine extension or modification of loan terms or lending activity inconsistent with the stated policies of management.
Audit Issues and Developments

Audit Issues

Asset Quality Issues. Credit quality and other asset-quality issues associated with commercial and consumer loans, investments, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of finance companies. The subjectivity of determining loan loss allowance, combined with sluggish economic performance and increased regulatory scrutiny, reinforces the need for careful planning and execution of audit procedures in this area. Auditors should carefully evaluate whether management has considered all factors relevant to the collectibility of the loan portfolio in determining the amount of the allowance for loan losses.

Failure of a finance company to adequately document its criteria and methods for determining loan loss allowances generally increase the extent of judgment that must be applied by auditors in evaluating the adequacy of management's allowances, as well as the likelihood that differences will result. The guidance in Statement on Auditing Standards (SAS) No. 57, Auditing Accounting Estimates, should be followed in auditing loan loss allowances. Another source of information on auditing loan loss allowances is provided by the AICPA Auditing Procedure Study, Auditing the Allowance for Credit Losses of Banks. The AICPA Audit and Accounting Guide, Use of Real Estate Appraisal Information, provides guidance to help auditors understand real estate appraisal concepts and information.

Fair Value Disclosures. Disclosures required under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments (see "Accounting Developments" section on page 9) will require many management estimates. Because no valuation methodology or format is specified for the variety of existing financial instruments likely to be encountered at finance companies, the determination and presentation of disclosure amounts may be particularly subjective, especially for those instruments that are infrequently traded. For example, when market quotations do not exist for a particular instrument, the fair value might be estimated on the basis of appraisals, discounting of expected cash flows, or other methodologies that include the use of subjectively determined assumptions. Auditors should follow the guidance in SAS No. 57 when auditing these estimates.

Other Valuation Issues. Like credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments
on loans in portfolios or the types of income and expense items included in valuations of loan-servicing assets have a significant impact on the recorded values of those assets. Further, falling interest rates have created an environment in which transactions involving gains-trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situation so that auditors may carefully assess and control audit risk.

Audit Developments

The Confirmation Process. Confirmation of balances is generally an important procedure in auditing the financial statements of finance companies. In November 1991, the AICPA's Auditing Standards Board (ASB) issued SAS No. 67, The Confirmation Process, which provides guidance on the confirmation process in audits performed in accordance with generally accepted auditing standards. It defines the confirmation process, discusses the relationship of confirmation procedures to the auditor's assessment of audit risk, describes certain factors that affect the reliability of confirmations, and provides guidance on performing alternative procedures when responses are not received and on evaluating results of confirmation procedures. SAS No. 67 specifically addresses the confirmation of accounts receivable, including loans, and explicitly prohibits the use of negative confirmation requests when control risk is assessed at the maximum level. This Statement is especially relevant to audits of finance companies because confirmation procedures are typically performed on cash, investments, loans, and deposit account balances. SAS No. 67 is effective for audits of fiscal periods ending after June 15, 1992. Audit Risk Alert—1992 includes further discussion of SAS No. 67.

Service Auditor Reports. In April 1992, the ASB issued SAS No. 70, Reports on the Processing of Transactions by Service Organizations, which provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

Because using service organizations affects both the auditor's understanding of the internal control structure and the auditor's assessment of control risk, the guidance in this Statement should be considered by auditors of finance companies that use service bureaus for processing significant information (for example, general ledger and trial balances, loan, or investment information), or that issue reports on the processing transac-
tions for use by other auditors. Audit Risk Alert—1992 includes further discussion of the provisions of SAS No. 70.

COSO Report on Internal Control. In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report Internal Control—Integrated Framework. The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management's reporting on internal controls over financial reporting.

The full report consists of four volumes: “Executive Summary” provides a high-level overview; “Framework” defines internal control and describes its various components; “Reporting to External Parties” provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and “Evaluation Tools” provides material to help in evaluating an internal control system.

The four-volume set (No. 990002CL) costs $50; the “Executive Summary” (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 14).

Attestation Standard. The ASB has exposed for comment a proposed Statement on Standards for Attestation Engagements, Reporting on an Entity’s Internal Control Structure Over Financial Reporting. This Statement, which would supersede SAS No. 30, Reporting on Internal Accounting Control, addresses engagements in which a CPA examines and reports on management's written assertion about the effectiveness of an entity's internal control structure for financial reporting. A final statement is expected to be issued in the first quarter of 1993.

Accounting Developments

FASB Financial Instruments Project

The FASB's current agenda includes a project on financial instruments that encompasses three primary segments: disclosures, distinction between liabilities and equity and recognition and measurement. In addition to these three primary segments, the FASB is addressing several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

Fair Value Disclosures. In December 1991, the FASB issued FASB Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments. The Statement requires disclosure of the fair value of financial instruments, assets and liabilities both recognized and not recog-
nized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement requires disclosure of descriptive information pertinent to estimating the value of financial instruments. Certain financial instruments (for example, lease contracts, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement. FASB Statement No. 107 is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets in the current statement of financial position. For those entities, the effective date is for fiscal years ending after December 15, 1995. *Audit Risk Alert—1992* includes further discussion of the provisions of FASB Statement No. 107 and its audit implications.

**Right of Setoff.** In March 1992, the FASB issued Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* The Interpretation defines right of setoff, as used in Accounting Principles Board Opinion No. 10, *Omnibus Opinion—1966,* and FASB Statement No. 105, *Disclosure of Information About Financial Instruments With Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk,* and specifies what conditions must be met to have that right. It also addresses the applicability of the general offsetting principle to forward, interest-rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple-forward, swap, option and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. The Interpretation is effective for financial statements issued for periods beginning after December 15, 1993.

**Marketable Securities.** In September 1992, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Certain Investments in Debt and Equity Securities.* The proposed Statement would require a positive intent and ability to hold debt securities to maturity as a precondition for reporting those securities at amortized cost. Securities not meeting the condition would be considered available either for sale or trading and should be reported at fair value. Unrealized gains and losses related to securities available for sale would be reported as a separate component of shareholders' equity; those related to securities held for trading would be included in earnings.

The proposed Statement would supersede FASB Statement No. 12, *Accounting for Certain Marketable Securities,* and related interpretations and amend FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* to eliminate mortgage-backed securities from that Statement's
scope. The proposed Statement would be effective for fiscal years begin-

Impairment of a Loan. In June 1992, the FASB issued an exposure draft of a proposed Statement, Accounting by Creditors for Impairment of a Loan. The proposed Statement would be applicable to all creditors and to all loans that are individually and specifically evaluated for impairment, uncollateralized as well as collateralized, except those loans that are accounted for at fair value or at the lower of cost or fair value. It would require that impaired loans be measured at the present value of expected future cash flows by discounting those cash flows at the loan's effective interest rate.

The proposed Statement would amend FASB Statement No. 5, Accounting for Contingencies, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of a receivable when assessing the need for a loss accrual. The proposed Statement also would amend FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, to require a creditor to account for a troubled debt restructuring involving a modification of terms at fair value as of the date of the restructuring.

The provisions of the proposed Statement would apply to financial statements issued for fiscal years beginning after December 15, 1993.

SEC Developments

 Marketable Securities. The staff of the Securities and Exchange Commis-
sion (SEC) has recently emphasized that management's intent to hold securi-
ties must be clear for amortized cost reporting. The staff has further stated that intent to invest in securities to manage liquidity interest rate, prepayment, or other such risks is inconsistent with an intent to hold. Accordingly, during the year, the SEC staff has required companies to reclassify certain securities from an investment to a held-for-sale category—that is, from amortized cost to the lower of cost or market value.

Other Than Temporary Declines. SEC Staff Accounting Bulletin (SAB) 59 provides guidance for determining whether a charge to income is neces-
sary for investments in marketable securities that have declined in value below cost. During 1992, the SEC staff emphasized that "other than tempo-
rary" does not mean "permanent," that management must consider all available evidence relating to the realizable value of equity and debt securi-
ties, and that there may be factors specific to a security that indicate that a decline is other than temporary. SAB 59 and related enforcement releases (Nos. 309, 316, and 416) indicate the SEC staff's position that the extent of the market decline from cost and the length of time the decline persisted are significant factors that may indicate required writedown in the carrying
value of that security. Objective, contemporaneous evidence, such as the financial performance and near-term prospects of the issuer and any recoveries subsequent to the balance-sheet date were also identified as factors that would be useful in determining whether a decline is other than temporary.

Allowances for Loan Losses. The SEC staff has emphasized that the requirements of Section 401.09 of the Codification of Financial Reporting Policies regarding the procedural discipline in determining loan loss allowances and accounting for in-substance foreclosures should be applied by publicly-held finance companies.

Consensus Decisions of the FASB's Emerging Issues Task Force (EITF)

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies.

In Issue No. 92-10, Table Funding Arrangements, the EITF considered whether an institution's cost of acquiring a loan through a table funding arrangement should be characterized as a commission on an originated loan or as the cost of acquiring the loan servicing-right and a purchase of a loan. In a table funding arrangement, an institution provides the original funding for a mortgage loan when the loan originator and the mortgagor close the loan. Immediately after closing, the institution acquires the loan and related servicing-right from the originator.

In Issue No. 92-5, Amortization Period for Net Deferred Credit Card Origination Costs, the EITF discussed the amortization period for net credit card origination costs deferred as direct loan origination costs under FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases. Specifically, the EITF considered whether such costs should be amortized over the period the cardholder is entitled to use the card (the privilege period), the privilege period plus the period the cardholder is entitled to repay any outstanding balance on renewal or cancellation of the card (the repayment period), or the period the cardholder is expected to be entitled to use the card, including anticipated renewal periods (the cardholder-relationship period). Further discussion of the issue is expected at future EITF meetings. In July, the EITF recommended that the FASB initiate a full-scope project on credit card accounting issues.

In Issue No. 92-2, Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse, the EITF reached a consensus that obligations recorded by a transferor under the recourse provisions relating to the transfer of a receivable should include all probable credit losses over the life of the receivable transferred, and not only those measured and recognized under FASB Statement No. 5, Accounting for Contingencies. The EITF also
reached a consensus that recognition of recourse obligations on a present value basis is acceptable if the timing of the estimated cash flows can be reasonably estimated. The consensus also addresses acceptable rates and other conditions that apply when such obligations are discounted.

In Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions*, the EITF discussed whether accounting for complex options and similar instruments should be guided by FASB Statement No. 52, *Foreign Currency Translation*, EITF Issue No. 90-17, *Hedging Foreign Risk with Purchased Options*, or some other approach. At its November 21, 1991, meeting, the EITF reached a consensus requiring certain footnote disclosures about the method of accounting for, the nature of, the hedging period for, and the amount of gains and losses on complex options and similar transactions. At the EITF's March 1992 meeting, the SEC observer stated that the SEC staff will object to deferral of realized or unrealized gains or losses contemplated within the scope of Issue No. 91-4 for hedges of anticipated, but not firmly committed, foreign-currency transactions. The FASB's current project on hedge accounting will likely address the issues raised, and no further EITF discussion is planned.

**Accounting Standards Executive Committee (AcSEC) Activities**

*Accounting for Foreclosed Assets.*  AICPA Statement of Position (SOP) 92-3, *Accounting for Foreclosed Assets*, was issued in April 1992 and applies to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992. SOP 92-3 sets forth a rebuttable presumption that foreclosed assets are held for sale and requires them to be classified in the statement of financial position as assets held for sale and reported at the lower of (1) fair value minus estimated costs to sell or (2) cost. On initial adoption, the carrying amount of existing foreclosed assets held for sale should be adjusted to the lower of (1) fair value minus estimated costs to sell or (2) cost as of the date of adoption. Assets in this classification should not be aggregated for the purpose of determining any necessary adjustment. In addition, senior debt associated with the acquired assets should be recorded as a liability as opposed to a reduction of the carrying amount of the assets. Foreclosed assets held for the production of income should be treated the same way as they would be had the assets been acquired in a manner other than through foreclosure.

Auditors should be aware that finance companies for which adoption of this SOP will result in a change in accounting principle should disclose the nature of the change and should include any adjustments in income from continuing operations in the period in which the change is made. SOP 92-3 is especially relevant to finance companies involved in real estate lending in areas that have been particularly hard hit by the recession.
SOP 92-3 contains no guidance on the accounting treatment of results of operations related to foreclosed assets and in-substance foreclosed assets, or on how the cost of the assets is affected, if at all, during the holding period. The AICPA issued an exposure draft of an SOP, Accounting for Results of Operations of Foreclosed Assets Held for Sale, during the fourth quarter of 1992. The proposed SOP would require that after foreclosure, the net of revenues and expenses (recorded on the accrual basis) related to operating or holding the property be credited or charged to income as a gain or loss on holding the asset. Further, the proposed SOP would require that depreciation expense be recognized on depreciable foreclosed assets held for sale that are being operated beginning one year after acquisition.


ADC Arrangements. An AcSEC task force is developing a proposed SOP that will address accounting for acquisition, development, and construction (ADC) arrangements, including how lenders should report proportionate shares of income or loss on ADC projects, whether depreciation should be considered in determining income or loss, reporting of interest receipts, and the treatment of unrealized appreciation of the property. An exposure draft is expected to be issued in 1993.

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This Audit Risk Alert supersedes Finance Companies Developments—1991.

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in Audit Risk Alert—1992, which was printed in the November 1992 issue of the CPA Letter.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.